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UNCLAS SECTION 01 OF 02 BOGOTA 011257

SIPDIS

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TAGS: ECON ETRD EINV CO SIPDIS
SUBJECT: Colombia's Capital Control Regime - Ineffective and Politically Motivated

¶1. SUMMARY: Colombia's Central Bank has used capital controls to provide macroeconomic stability both before and after the liberalization of the economy since 1967. The latest controls were enacted in late 2004 in hopes of stemming the flow of speculative capital as a response to exporter complaints regarding the peso's appreciation against the dollar. These controls have proven ineffective and the Minister of Finance has promised their revocation.

URIBE SIZED CAPITAL CONTROLS

¶2. At the close of 2004, the exporter community pressured the Uribe Administration to do something about the strong appreciation of the peso, which they blamed on speculative capital flows as well as increasing remittances from abroad. In a political move, the Administration issued a decree implementing capital controls as a means of preventing short-term speculation on the peso. The capital controls targeted short-term portfolio investments and required that investments remain in the country for at least one year. Most economists and the Ministry of Finance, the Central Bank and the Stockmarket Commission (Superintendencia de Valores) were not in favor of implementing the controls as they felt that they did not address the major causes of the peso's appreciation - rising export revenues from commodities and increasing repatriation flows.

CAPITAL CONTROL RESULTS

¶3. Despite the capital controls, the peso continues to appreciate against the dollar and Colombian exports continue to grow. In 2004 and 2005 the Peso appreciated a total of 25 percent, which exporters claimed would hurt their competitiveness abroad. Despite the loss of competitiveness, Colombian exports grew 37 percent in the first 6 months of 2005 to 10.1 billion USD. Bankers note that the controls have slowed short term capital inflows, but 2005 is shaping up to be a good year for foreign direct investment (FDI). Portfolio investment, however, dropped from USD 300 million in 2004 to USD 113 million as a result of the controls. FDI through March 2005 was USD 822 million (33 percent growth over 2004) and the estimated level of remittances for 2005 is 3.3 billion USD (24 percent above 2004).

HISTORICAL USES OF CAPITAL CONTROLS

¶4. The liberalization of Colombia's rules in capital inflows began in the early 90's, before which the GOC used a variety of capital controls to maintain stability. In a two step process, Colombians and Colombian firms were given the right to issue bonds in foreign capital markets and access to credit in foreign currency from both local and foreign institutions. Colombian residents were also authorized to invest freely in liquid assets abroad. The liberalization resulted in steadily increasing capital inflows beginning in 1992 and peaking in 1997.

	Net Foreign Direct Investment (US$ Million)	Net Foreign Portfolio Investment (US$ Million)
1990	500	0
1993	959	145
1995	968	165
1996	3,111	292
1997*	5,639	592
1998	2,032	-265
1999	1,468	-27
2000	2,395	1,332
2001	2,525	3,381
2002	2,115	-1,031
2003	1,793	104
2004	2,739	743

Source: Central Bank, Coinvertir

¶5. However, the capital account liberalization had its own capital controls. A reserve requirement was implemented obligating issuers of foreign currency debt to maintain a non-remunerated dollar deposit at the Central Bank. This volume-based capital control was intended to discourage capital inflows and short term speculative behavior. Additional restrictions were implemented on the net foreign exchange position ("posicion propia") of financial intermediaries preventing them from funding

peso loans with external liabilities; which was designed to limit potentially destabilizing asset/liability mismatches within the financial system. Restrictions on dollar denominated deposits also helped to limit the incentive to speculate on foreign exchange markets.

COMMENT

¶6. The Central Bank has bought 2.9 billion dollars of reserves in 2005 to counter the increasing value of the peso. In addition, net portfolio capital inflows have, in fact, risen markedly since the introduction of new capital controls. There is a great deal of confidence among those knowledgeable about Colombia that the stage is set for sustainable long term growth in Colombia. Increased security has allowed significant new investment (see Bogota 10027 for more information of favorable trends). These trends prompted the Finance Minister to declare in mid-2005 that the controls would be eliminated. Historically, capital controls helped stabilize the economy's transition from an administrative control regime to a liberal regime, but the IMF, the Central Bank and many in the private sector agree that the current control was more political than economic in nature.

¶7. Nonetheless, many in Colombia recognizing the small size of the economy in global terms are reluctant to foreswear some type of capital market regulation completely. They fear currency and capital markets will be buffeted by regional and global trends which could play havoc with domestic markets. One often cited example is the period from 1999 to 2001, when successive debt crises in Brazil and Argentina raised risk premiums on Colombian debt and affected currency values when there was no objective reason for such a market reaction.

¶8. The impulse to use government regulation to control so called market excesses is quite strong, even if the controls have proven futile. (end comment)

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